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E.O. 12958: DECL: 09/17/2018
TAGS: EFIN ECON PINR RS
SUBJECT: RUSSIA'S WORSENING FINANCIAL CRISIS

REF: MOSCOW 2800

Classified By: Ambassador John R. Beyrle, Reasons 1.4 (b/d).

Summary

¶1. (C) Russia's stock markets closed at noon today, September 17, after a 5.5 percent fall in the benchmark RTS index in the preceding 15 minutes. This spectacular fall followed one of the worst days in the history of Russia's markets. On September 16, the RTS dropped 11.5 percent and its sister MICEX index an astounding 17.5 percent before regulatory officials suspended trading early. The losses of this week, driven by plummeting oil prices, the events on Wall Street, as well as home-grown problems, including the aftershocks of the war in Georgia, followed a week in which sharp losses finally prompted the GOR to take action and try to calm the markets. President Medvedev, Prime Minister Putin and other senior leaders' efforts to talk up the economy, however, have so far been in vain, as have been large infusions of liquidity. Analysts with whom we discussed the crisis were unsure of its severity and what steps the GOR should take next but all are calling for government action before the situation gets further out of hand. End Summary.

RUSSIAN MARKETS COLLAPSE, CLOSE EARLY

¶2. (C) Trading was suspended early on September 17, at noon, following a spectacular fall in the benchmark RTS index of roughly 5.5 percent in the preceding 15 minutes. This followed one of the worst days in the history of Russia's markets. On September 16, while the Dow Jones Industrial Average was falling a panic-inducing 4.4. percent in the U.S., the benchmark RTS index fell 11.5 percent, wiping out over $100 billion in shareholder value in one day. Its sister index, the MICEX, fared even worse, falling 17.5 percent. Both indexes closed early on Tuesday. They reopened on Wednesday with modest rises before the bottom fell out just before noon.

¶3. (C) Just two days earlier, on September 15, two of the most respected Russian Chief Economists, Troika's Evgeniy Gavrilenkov and Deutsche Bank's Yaroslav Lissovolik had both confidently predicted to us that the RTS index would go no lower than 1100 points and would soon rebound. However, the RTS breached the 1100 barrier early in Wednesday's fifteen-minute free fall, ending at 1060 points when the

market closed. Analysts, who have been confidently predicting a rebound for weeks, appear stunned at the latest turn of events. UralSib's Chris Weafer, in his morning note to clients, described yesterday as a "black swan" event that defied both expectations and predictions. He is likely to be equally nonplused after today's losses.

¶4. (C) Many of the local analysts echo RenCap's Deputy Chairman Bob Foresman, who told the Ambassador September 16 that the sudden and continuing fall in value of Russia's natural resource companies made no sense. These were not retail companies; they owned real assets that had intrinsic value that far exceeded the companies' current market capitalization. Weafer called it inexplicable that Gazprom, the world's biggest energy firm, would fall 17.9 percent in one day or that Rosneft, with some of the world's largest proven oil reserves, would fall 21.3 percent.

¶5. (C) Analysts have also cited Russia's strong fundamentals to explain their shock and dismay at the latest developments. Lissovolik's morning note on September 17, echoing what he told us in private a few days earlier, stressed that this current crisis was nothing like 1998. Most of the economy's fundamentals, especially GDP growth and the trade and budget balances, remained strong. Most importantly, the country is sitting on more than $500 billion in reserves and other funds that it can deploy to stabilize the situation. Weafer also pointed to the reserves, the world's "third largest," as well as Russia's oil and gas revenues, still at $850 million a day despite the sudden drop in oil prices, to justify his continued optimism in the face of the apparent meltdown.

GLOBAL FACTORS BUT WITH DOMESTIC ACCELERATORS

¶6. (C) Foresman told the Ambassador external factors were the main cause of the collapse in Russia's markets. He argued that the drop in Russia's markets was similar to that of other emerging markets and was an outgrowth of tighter credit markets and a global move away from risk. He said the market collapse was also closely tracking the global fall in the price of oil. The Ambassador noted in response that it was just a few short months ago, at the St. Petersburg Economic Forum, that President Medvedev had confidently pronounced Russia a "safehaven" from the global financial crisis that was immune to external shocks.

¶7. (C) Most other analysts with whom we talked in the last few days also blamed the fall in Russia's markets primarily on external causes, especially softening oil prices and tightening international credit. However, Lissovolik and Gavrilenkov both also acknowledged the role of domestic causes, including the TNK-BP dispute, the Mechel incident, and the war in Georgia. JP Morgan's Michael Marresse went further, noting that the markets had yet to price in Russia's increased "geo-political" ambitions, which he said threatened to undermine the good financial governance that was the foundation of Russia's recent prosperity. He said that because of this, the markets had further to fall and that when they did rebound, the bounce would be smaller.

¶8. (C) With investor confidence falling and capital fleeing, the markets' fall has become self-generating. Margin calls and redemptions are now the main factors according to Weafer and others. Much like the decline in housing values in the U.S. created a credit crisis, the decline in stock values in Russia, used as loan collateral or leveraged, has created a credit crisis in Russia with investors unable to meet their debt obligations and creditors seizing and selling shares. Marresse and his JPMorgan colleague, Bob Fernandez, the VP of JPMorgan Russia, agreed that although economic fundamentals remained relatively strong, there would be consequences from the gathering crisis. They predicted bankruptcies among smaller banks and in the retail, real estate, and construction sectors. Foresman also said many companies in debt would be unable to refinance in the current credit environment and could become insolvent.

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CHARM OFFENSIVE, LIQUIDITY INFUSIONS FAIL; WHAT NEXT
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¶9. (C) In response to the crisis, the principal GOR action to date is what RenCap's Head of Research, Roland Nash, called a "charm offensive" to win back investor confidence. Nash was referring specifically to Medvedev's widely reported comments at the end of last week that the GOR would take action to restore the markets to their early-2008 levels. In general, after weeks of ignoring the crisis, Medvedev, Putin, First Deputy Prime Minister Shuvalov, Finance Minister Kudrin, and Presidential Assistant Dvorkovich have all been making themselves available to business groups and journalists in an attempt to signal that the Russian Government cares about investor sentiment. In that same vein, Putin is planning to hold a very public meeting today in Sochi with high-profile CEOs from key global multinationals present in Russia.

¶10. (C) The GOR's message has evolved over the past ten days as the situation has worsened despite their charm offensive. A week ago, Putin and Medvedev were both adamant that the causes were external and largely the fault of the U.S.-induced global financial crisis. They also said the fall in Russia's markets had nothing to do with the war in Georgia, and that the situation was only temporary -- the markets would soon rebound. However, by the end of the week, Medvedev for the first time acknowledged that some of the causes could be domestic, perhaps 25 percent, including the war in Georgia. However, Medvedev also said the war had been worth the price and promised the GOR would take action to restore stability to the markets.

¶11. (C) Lissovolik said the GOR's original intent was to try to talk the markets up and avoid taking any real action. When that failed, they next moved to inject liquidity onto the Russian financial system. Since September 12, the Russian Central Bank has injected more than $50 billion into the system, mostly through government auctioned "loans" to the banking sector. Gavrilenkov acknowledged that the CBR was also printing money to finance liquidity and that while the effects could be inflationary, he defended this as the lesser of two evils. However, despite the CBR's best efforts, domestic credit markets are still freezing up as banks and other lenders restrict their lending activities and attempt to shore up their precarious balance sheets.

¶12. (C) Analysts and businessmen, foreign and Russian, are calling for government action. Aleksandr Shokhin, the head of Russia's main business association RSPP told Medvedev at a public meeting with his group September 15 that the government needed to help businesses. Shokhin called for tax cuts. Others are calling for the government to intervene directly in the markets, using the Reserve and National Welfare Funds' combined $175 billion to directly buy Russian equities and thereby prop up the markets. Marresse said another idea under discussion was to extend government support beyond the major banks who are currently receiving loans to include security firms and brokerage houses; Russia's shadow banking system.

¶13. (C) Foresman compared the situation to the U.S., where he said Treasury Secretary Paulson and other key decision makers would have to decide when and how to intervene. Gavrilenkov however, said the GOR as yet has no mechanism with which to intervene directly and buy Russian equities. Changes to the rules governing the National Welfare Fund allowing such purchases are being considered and are expected to be issued in early October. However, Lissovolik and Gavrilenkov both saw these rule changes as problematic, opening up a Pandora's box of moral hazard that would lead to what Alfa Bank's Natalia Orlova called a "feeding frenzy" of demands for state support (reftel). Marresse also cited the risk of GOR overreach in the interest of maintaining growth, especially with respect to expenditures, when what the situation called for was the cautious approach Kudrin was advocating. It was not 1998 yet, Marresse said, but if the GOR played this wrong

it could turn a crisis into a catastrophe.

Comment

¶14. (C) A month ago the GOR was riding high, the economy booming with oil prices threatening to reach $200 a barrel. How things change. Instead of an opportune moment for a war against Georgia, the GOR has stumbled into a full-blown financial crisis that seems to be getting worse by the day.
BEYRLE